

How VCs Deploy Operating Talent To Build Better Startups

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Most venture-backed startups fail. Shikhar Ghosh, a senior lecturer at Harvard Business School, estimates that 30-40% of high-potential startups liquidate their assets and lose all their investors' money. About three-quarters don't recoup the invested capital. And roughly 95% never reach the projected revenue or breakeven point.

While it's become easier to start a company, building one that endures remains an immense challenge.

I revel in the adolescent phase of startups. Once a product is meeting a real market need and the company receives institutional financing, it's time to scale. But this process causes uncomfortable growing pains.

This transition – from discovery to execution – is fraught with risk. Scale too soon and face premature death. Or make a poor decision and cripple the company's growth potential. More than 30% of high-growth entrepreneurs surveyed acknowledge making one or more bad decisions or encountering significant difficulty in execution.

The Rise Of VC Operating Partners

The financial returns of VC funds over the last decade are weak. Data from the Cambridge Associates U.S. Venture Capital Index suggest returns of 4.41%. Many are wondering if there is a better way to build a startup.

Of all places, private equity might contain some clues.

When I was a management consultant at Bain, several of my colleagues switched into private equity. The partners and managers advised them to join the deal side, not operations. In PE, the focus is on picking winners and financial engineering – not adding value to the investments. It bothered me.

This imbalance changed during the recession. A study of PE exits revealed that operational improvements (e.g., organic revenue growth, cost cutting, restructuring, etc.) drive 71% of the value creation.

Struggling with poor performance, VCs have taken notice, adding Operating Partners to their General and Limited Partners. Dick Strayer, a psychologist and professional advisor to countless VC firms, described this trend back in 2008, saying "...VCs often aren't the best investors to be on boards. An operating partner who maybe takes the seats of six or eight boards that need a lot

of work — boards of companies that need to be sold or evaluated and shut down — is very helpful because that’s the lowest interest profit generator for a successful venture investor.”

The VC industry is going through a fundamental transition. “VCs have long been structured as ‘upside-down pyramids’ in which GPs outnumber more junior employees,” explains David Teten, partner at ff Venture Capital and co-author of the forthcoming paper, *The Lower-Risk Startup: How Venture Capitalists Increase the Odds of Startup Success*. “Post-investment activities such as operational support for portfolio companies, however, can be delegated and benefit from economies of scale.”

He agrees with HBS Professor Noam Wasserman, saying “pyramidal structures are the most efficient means of systematizing and delivering this support due to the benefits of leverage, delegation, and specialization.”

These models are observed in some form at the most prominent VC firms in the country. He points out that Accel has a Venture Development group and firms such as Oak Investment Partners and Bessemer have Operating Partners to lend added support. Union Square Ventures hired a General Manager for its portfolio in 2010.

Andreessen Horowitz (“a16z”) has taken it a step further, offering “structured support through one of four operational support teams, focused on executive recruiting, marketing/PR, technology, and business development.” They have seven General Partners (announcing the addition of Chris Dixon in November) and more than 40 operational staff.

Teten uses this TOPSCAN framework to summarize the portfolio operator model:

- **Team Building:** designing and recruiting for a startup’s most important asset, its human capital base
- **Operations:** enhancing administrative, accounting, legal, and technological capabilities
- **Perspective:** strategy, competitive positioning, defining the target market, and scoping the product
- **Skill Building:** building the right skills, especially for senior management
- **Customer Development:** identifying and gaining access to the right customers
- **Analysis:** how entrepreneurs measure, understand, and report the performance of their early-stage companies
- **Network:** the cheapest and sometimes most value-added service that an investor can provide is access to his network, particularly to potential investors and acquirers

Teten found in his research that all of the funds with the most developed portfolio operator models have top-quartile returns (above 20% IRR). Lightbank and First Round Capital, in addition to a16z, are notable examples of portfolio operators.

The Founder’s Role

During the growth phase, the role of the founder is carefully scrutinized. Most VCs prefer to grow the founder into the CEO, but few are capable of making the monumental leap in responsibilities. In rare cases, the founder needs to be replaced because he is sabotaging the growth. A clear warning sign, according to Vinod Khosla, is when employees perpetually leave because of the founder.

One compromise, rather than make an either/or decision, is to augment the founder with an experienced operator. Teten advises entrepreneurs to consider outside support “if there are large chunks of the company you don’t want to manage.” This approach works well in a two scenarios: the founder prefers to remain focused on product and engineering or spends the majority of his time in external relations. In either case, a capable GM can be a boon to the founder/CEO, ensuring that the product vision and company strategy are supported by execution. But it’s not a cure-all: Groupon’s Andrew Mason, for example, has struggled to retain a COO.

There are a number of examples of this balanced leadership approach. Eric Schmidt joined Larry and Sergey at Google to form the triumvirate that oversaw Google’s phenomenal growth in the 2000’s. Sheryl Sandberg joined Mark Zuckerberg as Facebook’s COO. Now she’s a billionaire.